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CAPITAL MARKET DEVELOPMENT IN NEPAL: LESSONS LEARNED

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INTRODUCTION

Financial markets are a catalyst in the development of the country's economy. As such, developed economies have highly sophisticated financial institutions. Over the past decade or two, many developing economies have established capital markets as they moved towards more liberal economic policies. These emerging markets have shown extraordinary growth with very high volatility, which have attracted many investors into these markets. In 1994, the Government of Nepal established a stock market with the technical assistance of the IRIS Center at the University of Maryland under the USAID sponsored Economic Liberalization Project. This paper looks at the institutional changes and the consequent market behaviour that took place in this process and summarizes the lessons learned and needed policy responses drawn from the post 1992 Nepal experience of capital market development.

BACKGROUND

Financial markets play a fundamental role in the economic development of a country. They are the intermediary link in facilitating the flow of funds from savers to investors. By providing an institutional mechanism for mobilizing domestic savings and efficiently channeling them into productive investments, they lower the cost of capital to investors and accelerate economic growth of the country.

Financial intermediation between borrowers and savers is done by commercial banks. This credit market enables debt financing for investments. An alternative method of intermediation is through equity financing. This is only possible through the development of capital markets.

Capital markets, which deal with securities such as stocks and bonds, are associated with financial resource mobilization on a long term basis. By raising capital directly from the public, they lower the cost of capital. Capital markets also allow for wider ownership among the public, thereby distributing risks and wealth amongst smaller investors. For investors, they provide an effective vehicle for making investment choices which suit their own preferences of risk and returns based on available information. As such, capital markets help the economy to generate more savings and productive investments. A basic feature of an efficient capital market is constant liquidity, i.e., an easy mechanism for entry and exit by investors. This requires sufficient volume and size of transactions in the market.

Typically in developing countries, for various economic and policy reasons, financial markets are underdeveloped. In those countries where a capital market does exist, it is in a very rudimentary state. Private wealth and investments are concentrated among several large companies and individuals. The choice of market instruments is also very limited. As a result, these capital markets are very narrow based. They are constrained by limited investment opportunities and low income and savings rates. In many cases, the economy has high inflation, leading to a savings disincentive and capital flight.

Financial sector development is a lengthy, evolutionary process. It is an indicator of the state of economic development of the country, since an efficient well-developed financial market is only possible when there is substantial income generation and investment opportunities.

DEVELOPMENT OF A CAPITAL MARKET IN NEPAL

Nepal is a landlocked, mountainous country situated between India and China. It is a small, mostly agrarian based economy, sharing an open border with North India. With a GDP of \$ 3.75 billion, Nepal has a per capita income of \$ 200, one of the lowest in the world. As per 1995 figures, agriculture constitutes nearly 42% of GDP, whereas manufacturing sector comprises of only 9.4% of GDP. The financial and construction sectors each constitute about 10% of GDP. Some of the country's economic indicators are given below:

Economic Indicators	Amount
Gross Domestic Product (1994/1995)	\$ 4210 mill.
Gross Domestic Savings (1994/1995)	\$ 496 mill.
Per Capita Income (1995)	\$ 200
Inflation (1995)	8%
90 day T-Bill Rate (1996)	12.5%
Total Deposits of Commercial Banks	\$ 1190 mill.
Total Loans Outstanding to Pvt. Sector	\$ 1101 mill.

Source: The Economic Survey, 1995-1996

Industrial development began in Nepal only in the mid-sixties, when the Government began establishing manufacturing industries such as the jute industry, cement factories, and sugar factories. In order to support this industrialization process, government actively promoted financial institutions, such as commercial banks and capital market institutions.

The Nepali capital market had its beginnings with the establishment of the Securities Marketing Center in 1976. In 1984, the Securities Exchange Act was promulgated and this institution was converted into the Securities Exchange Center (SEC) under the ownership of the Nepali Government, Nepal Rastra Bank - the Central Bank - and the Nepal Industrial Development Corporation - a government owned industrial development bank. The main function of SEC was to assist in the development of a capital market by performing the role of a broker, underwriter and share issuer, and to sell government bonds. It operated an over the counter market for company shares and government bonds. After the inception of the Securities Exchange Center, shares of various manufacturing, trading and banking companies became listed. Interestingly, the listed shares were dominated by public enterprises during this stage. Between 1984 and 1990, 42 companies were listed, out of which more than 25 companies had some form of government ownership.

The real boost into the capital market in the form of a private sector led growth began with the financial sector liberalization. In the mid-eighties, Nepal opened its doors to foreign investors as joint venture partners in the banking sector, which revolutionized commercial banking services in Nepal. Since then, a variety of private sector based financial institutions have evolved. In 1992, the Finance Companies Act was amended. This enabled finance companies to be established to function in various areas such as leasing, housing finance, and hire-purchase. These institutions were also allowed to perform capital market functions such as share issue, portfolio management, market making and custodial services.

The growth of these financial institutions was complemented by the establishment of the Nepal Stock Exchange. In 1993, the Securities Exchange Act was amended. The Securities Exchange Center was converted into the Nepal Stock Exchange for securities trading by private brokers and the Securities Exchange Board was established for oversight functions as a regulatory body. This amendment also permitted private sector market intermediaries and set the operating guidelines for intermediary functions such as broking, market making, issue management, and portfolio management.

The changes that were seen in the market with these regulatory and institutional changes were phenomenal. It is only since this change in 1993 that a true capital market has evolved where prices are actually determined on a market basis. This process of capital market development in Nepal holds valuable lessons for newly emerging markets. Many of the issues faced are common across developing countries with nascent market economies and democratic governance. In trying to analyze the market development process, three key factors have been identified, whose changes influence the market behaviour. These are:

- i) Environment (rules and regulations, other external factors such as policies, economic conditions);
- ii) Products (items being traded); and
- iii) Players (buyers, sellers, intermediaries).

i) Regulatory and Economic Environment:

a) Regulatory Environment

The regulatory environment, while still nascent, has altered significantly in the past two years. Most activities are guided by the Securities Exchange Act and the Companies Act. In addition, guidelines such as the primary issue guidelines, have been announced by the Securities Exchange Board. All transactions work relating to stock exchange are guided by the Exchange's rules and regulations.

Chronology of Policy Announcements

1984: Securities Exchange Act promulgated, SEC established
1993: Securities Exchange Act amended, SEB and NSE established
Mutual fund floated
1994: Trading by private brokers begin, Mutual Fund guidelines announced
1995: New Issue Guidelines formed
1996: Policy announcement to allow foreign institutional investors,
New listing rules formed
Amendment to Securities Exchange Act and Regulations drafted

b) Economic Environment

The economic environment which provides the main stimulus for a healthy growth of the capital markets has also influenced this market quite considerably. In 1992, the Finance Companies Act was amended. As a result, in the three year period, more than 30 finance companies were established all of whom have made public share issues and are being listed on the Stock Exchange. This growth in the financial sector was further boosted by the liberalization of the commercial banking sector. The Central Bank gave licenses to more than 5 joint venture commercial banks. The commercial banking industry has historically performed very well in the capital markets, which infused a lot of investor interest in the market during the early stages of its development. Together, these sectors accounted for 65% of the turnover and 36 % of the total amount of public issue in 1994/95. In Nepal, the financial sector has witnessed tremendous growth and profitability, in contrast to the manufacturing sector where profitability has been very low¹. The manufacturing companies which are listed on the Stock Exchange have typically been very stagnant because they are primarily government owned public enterprises or newly established companies without a long track record of profitability. Privately owned companies which are profitable generally hesitate to go public owing to tax or other reasons. As a result, the growth of the stock market has mainly been due to the liberalization and the resulting growth of the financial sector (commercial banks and finance companies) rather than that of the industrial sector.

Government's privatization policy also enabled new industrial companies to enter the stock market. In 1994/95, of the total public issue, 31% was issues of privatized companies.

In 1992, the Government brought out the Industrial Enterprises Act and enforced the one-window policy to actively promote foreign investment in the country. This resulted in some new joint venture companies in the country, which accounted for 29% of the public issue in 1994/95.

¹ Trade and services sector account for a significant portion of Banks' earnings.

ii) Market Instruments :

These are the products being traded. In the Nepalese capital market, these are purely limited to equity shares and preference shares which are traded on the Stock Exchange. A mutual fund was also floated but has not been listed in the Stock Exchange and has been closed after about two years of Over The Counter (OTC) trading. No active market exists for treasury bills, which are currently floated on an auction basis by the Nepal Rastra Bank to commercial banks and private companies. Government bonds used to be traded in the Securities Exchange Center. But following its conversion into the Stock Exchange, they are now traded over the counter by a government owned investment trust company. No other forms of money market instruments are available.

iii) Market Intermediaries and Investors:

This group represents the players in the market. The most significant change that occurred in the Nepalese capital market in 1993 was in this area. Previously, all transactions relating to capital markets from public issuance to trading and regulating were conducted under one roof, the Securities Exchange Center. The Securities Exchange Act amendment changed this government monopoly by introducing private intermediaries such as brokers, merchant banks and market makers. A separate regulatory body, the Securities Exchange Board, was created. However, the ownership of the Stock Exchange remained with the government. As a result of this change, there are now 28 brokers, half of whom are institutional brokerage firms, and 6 market makers. There are currently 4 active issuing companies, 2 investment funds and 10 finance companies who have licenses as market makers for government bonds. While no foreign investors are present, a recent policy announcement was made by the Securities Exchange Board to allow foreign institutional investors into the secondary market. Aside from brokerage functions, most of the other functions are being carried out by finance companies. Unlike, many other countries, these companies are also allowed to mobilize public deposits.

MARKET TRENDS

As a result of the interplay of the above three factors, the capital market performance in Nepal has witnessed a lot of changes. The growth pattern over the past four years is summarized in the following table:

Nepal Stock Market Trend (1993-1996)

Market Performance Data	1992/93	1993/94	1994/95	1995/96 (as of Apr.)
No. of Public Issues	5	14	11	10
Amount of Public Issue (Rs. in mill.)	53	243	204	217
Paid-up Capitalization (Rs. in mill.)	1413	2368	2961	3400
Market Capitalization (Rs. in mill.)	4000	14972	12963	11970
Annual Turnover (Rs. in mill.)	70	400	1054(*)	161
No. of Listed Companies	63	66	79	85
No. of Brokers and Market Makers	0	30	38	38

(*) includes Rs. 600 million in off-the-floor trading

(Source: Securities Exchange Board, NEPSE Monthly Reports)

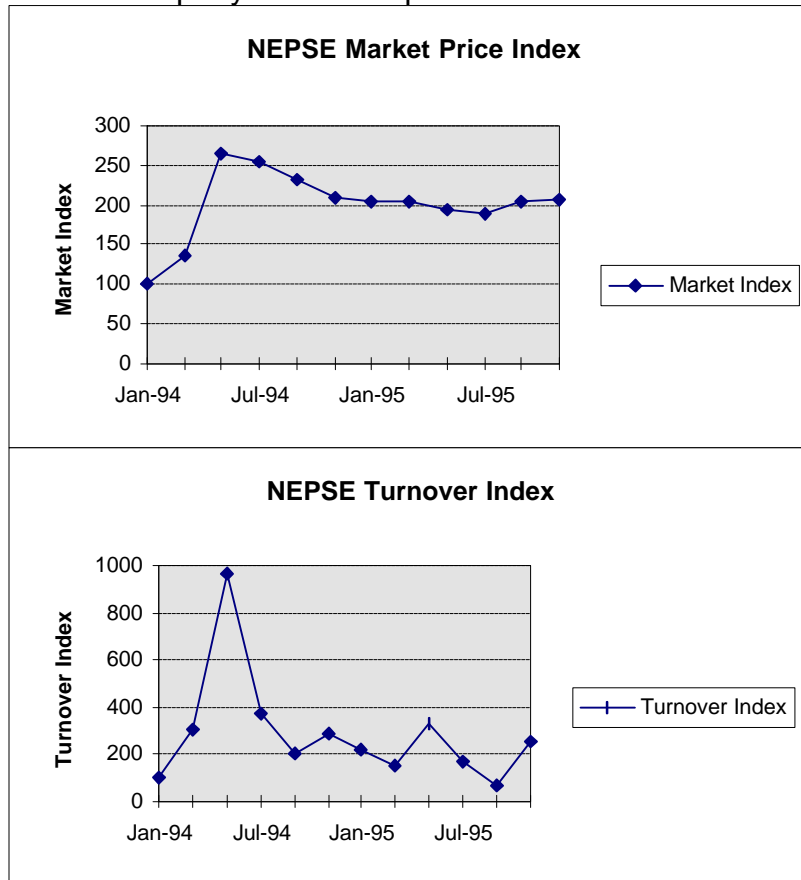
a) Primary Market

In the primary market, the amount of public share issues increased five times from Rs. 53 million in FY 1992/93 to Rs. 243 million in FY 1993/94. This high level of capital mobilization has been maintained at Rs. 204 million in FY 1994/95, with Rs. 217 million already issued by April 1996. Public demand for these issues is very high, as shown by the fact that most of these issues were oversubscribed. On the supply side, public issues of privatized companies and financial institutions continue to account for a significant portion of the primary market activity. With the government restarting the privatization program, more of these issues can be expected.

b) Secondary Market In the secondary market, the number of listed companies has been increasing steadily from 63 in 1992/93 to 85 at present. Similarly, the paid-up capital - a measure of the par value of listed shares - has also been increasing. At an annual turnover of Rs. 400 million last year (excluding the off-the-floor trading), trading has remained steady after an increase of about six times over the levels before the Exchange was opened. Trading continues to be dominated by financial institutions such as commercial banks, insurance companies and finance companies. This sector occupies more than 50% of the turnover whereas the manufacturing sector constitutes only 30% of the total turnover. This is mostly attributable to the better financial health of these organizations with regular dividend payouts in contrast to the manufacturing units.

While there has been marked growth in the secondary market, it has also witnessed high volatility, which is common among emerging markets. Trading of company shares had escalated enormously, fueling much speculative activity in the market in the absence of substantive financial information to backup the price movements. As a result, the all share price index (base price = 100 in Jan

1994) shot up to a high of 264 within six months. This unsustainable rise was checked in the latter half of 1994. Since then, the price index has remained stable at around 200. It is only now that the market price has come to levels which are supported by its fundamentals. Recent market activity shows investors have become more information sensitive and market movements are more aligned to the company's financial performance.



As can be seen from the above graph, the market underwent through three basic stages, namely, a) Speculative period (Jan 1994 - May 1994) b) Correction period (May 1994 - Nov. 1994) and c) Stabilization period (Nov. 1994 - present). The initial speculative period was the five month period following the opening of the stock market. During this period, the price index jumped up over 250%. This increase can be partially explained by the fact that regulatory and institutional rigidities prior to the opening of the stock market had constrained its normal growth leading to pent-up demand among investors. The share prices were generally undervalued. When these institutional constraints were relaxed, the liquidity in the market rose and prices increased to reflect the higher demand. However, the new price level did not stabilize. In the absence of sufficient information on the companies' financial performance, investors expected the prices to increase further based on the overall price increase in the market. This self-fulfilling expectational behaviour is characterized in a highly speculative market. This market scenario is also referred to as a 'bubble'.

This period was also marked by an escalation in turnover value which was driven more by a sharp price rise than by the number of shares traded. This is evident from the fact that during the six month speculative period, less than a million shares were traded whereas in the following one year period almost 4 million shares were traded. This resulted in very high market capitalization. As a result, market capitalization - a measure of the market value of the listed shares - , increased from Rs. 4 billion in 1992/93 to almost Rs. 15 billion in 1993/94.

The market correction period was the six month period following the speculative period. In the market correction period, share prices started to tumble from its peak. Share prices, which are ultimately determined by the company's underlying fundamental value, cannot keep increasing forever. As a result, investors began to offload their overvalued shares resulting in a drop in prices. This decline persisted for a prolonged period until the share prices were supported by their underlying value. At this point, the market entered a stabilization period. In this period, share price movements are based on the economic information of the company. This type of market behavior is quite prevalent in newly opened stock exchanges. There are many institutional problems inherent in such markets which result in this market trend. Some of the main problems which were faced by the Nepali capital market are discussed below.

PROBLEMS:As in most nascent markets, Nepal also went through a volatile period in its early years. In the section above, three market factors were identified whose dynamics influence the market behaviour. Given below is a discussion on some of the problems faced in each of these three areas, especially during the speculative market stage.

A. Market Instruments*Lack of Tradable Market Instruments*Tradable market instruments in Nepal are limited to equity shares. An alternate over the counter market existed for long-term government bonds. However, during the initial speculative period, bank interest rates were at their all-time low, with treasury bill rates in the range of 4.5% . Since bond trading was done at par, investors held on to their bonds and this market was very stagnant. Moreover, as interest rates on commercial bank deposits were very low, investor interest in the stock market was quite high as a higher return investment option. In the absence of alternative investment opportunities, the demand of shares built up heavily. This was particularly problematic in the initial speculative period, as it only fueled the price rise of already overvalued shares.

B. Market Intermediaries and Investors*An Oligopolistic Market Structure*In its early stages, the market had very few active members. There were 25 registered stock brokers of whom only about 10 were active. There were only 3 market makers. As a result of this oligopolistic structure, prices could easily be manipulated with very small transactions. This easily led to transactions being made on a speculative basis rather than on an investment basis. Similarly, when the market makers realized that they could

exert tremendous market power, rather than playing a stabilizing role by trading on the basis of company's underlying financial position, the market makers themselves made transactions on a speculative basis which pushed the prices up further. Prices rose for almost all shares without regard to the company's actual financial situation. Data for the first six months after the Stock Exchange was opened shows this rapid price escalation. In the six month period, monthly turnover index increased almost ten times for about a million shares traded. In contrast, turnover index in the following year came down substantially, almost to the previous year's levels, during which period almost 4 million shares were traded. This shows that during the initial period, the price rise was being driven upwards with fewer number of shares traded. *Functional Overlaps Amongst Intermediaries* Because of low business volumes, financial intermediaries such as merchant banks and brokers become engaged in multiple functioning, which according to developed country standards would constitute severe conflicts of interest. For instance, in Nepal, a market maker could also operate as a portfolio manager and a mutual fund manager. Similarly, auditors are also working as brokers. Some market makers are also sitting on the Board of Directors of listed Companies. Most interestingly, even regulators are directors of some of the market intermediaries. This is one of the glaring problems existing in Nepal which lends itself to insider information problems and conflicts of interest. As a result, market intermediaries can command substantial market power and easily manipulate the market. If not rectified over time, this may lead to a serious abuse of the system with its impending consequences and erosion of investor confidence.

C. Economic and Regulatory Environment

Insufficient Scripts

One of the most common problems in emerging markets is the scarcity of public companies. Typically in developing countries, business enterprises are small in nature, closely held usually within a family and are highly reluctant to go public. This hesitation usually stems from the fear of making their financial statements public, thus no longer being hidden from tax authorities. This is, by far, one of the biggest reasons in deterring private businesses from going public. Similarly, dealing with shareholders - most of whom are not well educated - is rather cumbersome to promoters. They also fear the loss of control to outsiders. In developing countries, where information is so scarce, businesses fear sharing this information to outsiders, especially competitors. Well established businesses have very strong relationships with commercial banks who will happily cover their financial needs. Hence, the need to resort to capital markets is less. As a result, the supply of shares in the stock market is limited.

In Nepal, this is evident from the fact that many of the companies listed are due to government mandate. Almost one third of all the listed companies have some

percentage of government or government enterprise ownership. Financial institutions, representing almost another third of the listed companies, are required by government mandate to make public issues. The only way to entice companies to go public is by offering fiscal incentives, which are nominal in Nepal. The Income Tax Act is silent on tax treatment of capital gains. This means that capital gains may be doubly taxed, once at the corporate level and again at the individual level. This is a severe drawback for companies to go public.

The relative dearth of supply of tradable company shares meant that prices were being driven up further in an unsustainable manner. This problem was most evident during the speculative period.

Competition with the Financial Sector

The growth of the capital market is intricately related to the state of financial markets such as the banking sector and government bond market. Usually, the banking sector plays a competitive role in the development of capital markets. In Nepal, while the banking sector was crucial in developing the capital market, the banking sector also plays a strong complementary role in fulfilling financial needs of businesses. Share markets are resorted to only when it is mandated by a government directive or if the company leverage has reached very high levels.

In 1994, bank deposit rates were ranging at a very low levels of around 6%-7% with inflation running at around the same rate. Investors viewed this market as an alternative investment opportunity. This pushed up further the demand for shares in the early speculative period. However, as interest rates began to creep up, demand for shares faltered. This has coincided with the market correction and stabilization period. While not enough data was available to derive the correlation, the relative size and influence of the banking sector can be seen from the fact that while market capitalization to GDP is only 6.5%, fixed deposits (long term maturity deposits) alone as a percentage of GDP is almost double that of market capitalization. Similarly, private sector outstanding loans as a percentage of GDP is 19%, more than three times that of market capitalization.

Regulatory Confusion

In Nepal, a Universal Banking modality has been followed. Under this system, deposit taking institutions such as commercial banks and finance companies are also allowed to participate in the capital markets. Since these institutions are regulated by the Central Bank as well as the Securities Exchange Board, the presence of multiple regulators adds to the confusion. A striking example of this is the approval for operation of a mutual fund by the Central Bank even before

the establishment of the Securities Exchange Board. In the absence of a coordinated effort whereby these institutions regulate by function rather than by institution, the enforcement capacity of these organizations is heavily undermined.

Enforcement

Perhaps the biggest problem that emerged in the capital markets in Nepal is the lack of teeth of the enforcement agencies. This can be attributed to several factors:

a) *Inadequate Legal System:* The Securities Exchange Act lacks clarity in terms of the regulatory purview of the Securities Board over the market intermediaries. It does not vest sufficient powers on the Board to issue and enforce the rules and guidelines. Rules and Regulations can only be issued with the approval of the Cabinet. More than four years after the Board's establishment, this has yet to be amended. Another example of this weak legal infrastructure has been the outdated Companies Act. This Act is yet to be amended to include the information reporting standards and accounting standards required for publicly traded companies and timely ownership transfers to ensure liquidity in such a market².

b) *Fear of Regulatory Overkill:* Market intermediaries are usually few in number and are engaged in multiple activities. At this infancy stage, regulators are constantly plagued with the dilemma of acting as a market promoter versus a market regulator. Regulators are worried of an "overkill" which may have a ripple effect in terms of investor confidence. This often results in extended forbearance with detractors. In a non-competitive, nascent market, regulators are often unable to enforce rules strictly. The NCM Mutual Fund is a typical case in point. When trading for the mutual fund was closed in direct contravention of its prospectus, the Securities Board was unable to suspend its license. This was primarily for fear of depressing the stock market further as investors begin to offload their mutual fund units. Similarly, whenever regulators have tried to delist companies who have not fulfilled the continuing listing requirements, it is the small investors who are hurt and not the listed companies, who are the reluctant participants in this process. In such a scenario, regulators can resort to little more than moral suasion in trying to enforce rules. The regulators are often held hostage by the regulated in this manner.

c) *Ownership:* A unique problem for proper enforcement in Nepal has been the ownership structure of institutions in Nepal. The Nepal Stock Exchange, instead

² An amendment to this Act, drafted with IRIS assistance, is currently being discussed in Parliament.

of being owned by brokers, is still owned by the Central Bank, Government and a semi-government enterprise, the Nepal Industrial Development Corporation. Hence, the Stock Exchange has yet to emerge as a self-regulatory body. Experience elsewhere has shown that regulatory enforcement over government-owned agencies is weak. This ownership structure has removed a layer of self regulation which is an international standard in this area.

The overlapping of institutional ownership has also undermined the regulatory capacity of the institutions. For example, Citizen's Investment Trust, a licensed intermediary under its own Act, which was promoted by the Securities Exchange Center, is today in direct competition with other private sector intermediaries in areas such as primary issues, fund management, and market making. The Executive Director of this company is the Executive Chairman of the Securities Exchange Board - a regulatory body. Such conflicts of interest and overlapping of roles has greatly undermined the credibility of the regulatory authoritative body in Nepal.

All these factors make it very easy to manipulate the markets, making the market quite volatile. This makes it all the more important to strengthen the regulatory capacity and enforcement ability of the regulatory bodies.

SUGGESTED POLICY RESPONSES

In any emerging market, the objective is to promote a healthy long term growth environment which will attract investors with more of an investment mentality than a speculative mentality. Given the market trend as seen in the initial years of the establishment of the Stock Exchange in Nepal, the role of regulators and promoters alike should be to maintain stability in an otherwise highly volatile market. Policy responses should be geared towards this end particularly during the initial speculative period, so that the market correction period is not very deep and investor confidence is not eroded. Some of the policy responses that need to be taken by the regulators as well as the government are as follows:

A. Increase Supply of Tradable Securities

Increase variety of market instruments

In the initial speculative period, the demand for market instruments is heavy. In Nepal, fortunately, the liberal economic policies adopted enabled more tradable scrips to be issued and listed. However, there was no variety in the types of instruments available for trading. Government bond trading was virtually stagnant. Corporate bonds did not exist. The Government ought to allow for a more variety of market instruments. Introduction of bonds, especially government bonds, in the primary and secondary market would have been very

timely. In 1995, 35% of the long term government bonds were held by non financial and non governmental organizations. The size of this market alone was more than Rs. 2 billion (15% of the market capitalization). This market alone would have provided a substantial float to the nascent securities market.

Provide Fiscal Incentives

Policymakers should also increase the supply of tradable companies on the Exchange. This is achievable only through fiscal incentives by the government. A two tier corporate tax structure should be set up in favor of public companies. Since debt financing allows for more tax deductability, alternative incentives should also be considered so that companies do not necessarily favor debt financing over equity financing. These measures could be a tax exemption for newly listed companies, a tax deduction of a certain percentage of costs of going public, or even a tax deduction of a certain percentage of profits distributed to public shareholders.

Issue Mandatory Legal Requirements

Mandatory laws and regulations requiring public offering by companies is quite effective in increasing the supply of corporate scrips. For example, all commercial banks and finance companies are required to issue a minimum of 30% of their capital base. Similarly, privatized firms are mandated to make a public float of 25% of their capital base.

Create Favorable Legal Environment

It is very important that corporate law, particularly, the Companies Act, is supportive of public issuance and does not have stiff requirements and procedures in going public, without sacrificing accounting and information disclosure requirements. Ultimately, the transaction cost of raising capital from the public has to be low enough in comparison to alternative financial mobilization vehicles. This is one area where Nepal has had considerable problems with the Companies Act, as exemplified by the fact that a minimum of 35 days is required by the Companies Act before a share transfer can take place.

B. Maximize Competitive Forces in the Market

Increase number of intermediaries

As in all nascent markets where the size of the market is very limited, there are naturally few players. However, it is important that no one institution can command significant market concentration making it easier to manipulate the markets. To this end, policymakers should try to create as much of a competitive atmosphere as possible. For this, policymakers need to license more intermediaries. At the time of licensing of the stock brokers, the Stock Exchange was advised against having more than 5 or 10 brokers. However, 25 brokers were licensed and soon enough, the Exchange was under pressure to license more brokers. With market makers, the experience was quite the reverse. Having only three market makers early on meant that they held substantial market power. As a result, there was a lot of volatility in the market. Not only should the number of intermediaries be maximized, but even their type and activities they can undertake should be increased while keeping their roles separate.

Promote Individual and Institutional Investors

Similarly, while the presence of institutional investors is important, the timing of their entry into the market is critical. Since they build up a substantial demand in the market, their entry should be timed only after there is a good increasing trend of the tradable number of scrips. For example, their entry during the speculative period probably would have driven the bull market up further. However, once the market has entered a stable and a more mature period, collective investment vehicles such as institutional investors (mutual funds, pension funds) should be introduced. Fiscal incentives, such as a low capital gains tax, should be provided to attract more investors. Similarly, legal amendments have to be made to enable pension funds to invest in this market rather than limit their investments to government bonds.

C. Develop Stronger Regulatory Environment

In any nascent market, it is but natural that the legal infrastructure is rather weak. But to maintain a long term healthy growth trend, it is expedient that proper rules and regulations exist for licensing of intermediaries, public issuance and listing of companies, and rights and obligations for market instruments. Some of the issues pertaining to the development of a healthy regulatory environment are:

Strengthen Oversight Agency

The Securities Exchange Board (SEB) is the oversight authority which should regulate all aspects of capital markets. Given the nature of the financial sector in Nepal, an institution may be under the regulatory purview of different agencies such as the Central Bank, Office of Company Registrar or SEB. Hence,

regulation should be by function, i.e. through guidelines issued for that particular capital market function, instead of by parentage.

Timely Amendments in the Legal Framework

As far as possible, capital market related activities should be encompassed within a centralized Act. It is inevitable that some duplication or conflict may occur between different acts, and that the existing legal framework may be inadequate. But regulatory development is an evolutionary process requiring continuous modifications as circumstances dictate.

Develop Self Regulatory Structure

An important element in capital market regulation is the presence of self regulatory bodies such as a Stock Exchange which is owned by brokers and develops its own rules and standards. Similar self regulatory organizations like Merchant Bank's Association and the Institute of Chartered Accountants should be encouraged. This level of regulation is conspicuously absent in Nepal. This is vital to develop the quality and integrity of the profession.

Increase Information Disclosure

Capital markets are highly information sensitive. In a limited market, it is probable that price manipulation takes place due to insider information which is extremely difficult to prove and take action upon. While this is a part of the regulatory function, the importance of adequate information dissemination cannot be overstated. Today, the annual publication of the Stock Exchange contains financial statements of listed companies only through 1994. Financial data is not readily available nor are uniform accounting standards applied. Hence, stock exchanges should try to disseminate as much timely public information as possible on corporate financial performance, which will stabilize any speculative trends in the market.

D. Liberal Economic Policies and Economic Growth

A healthy macroeconomic environment supported by favorable economic policies leading to increased savings and investments is the prerequisite for a stable and healthy growth of capital markets. For example, in many emerging markets, privatization of state owned enterprises has played a crucial role in

promoting capital markets. Privatized enterprises have constituted a significant portion of primary issues in Nepal. Ultimately, the status of capital markets is a reflection of the state of economic growth of the country.

CONCLUSION

Capital markets are a vital part of the financial development and economic development of a country. They provide an alternative vehicle for financial resource mobilization. In the past decade, many developing countries have also established securities markets. In Nepal, the Stock Exchange was established in 1994, providing a marketplace for securities trading by private brokers. The objective of this paper is to provide a synthesis of the process of development of the stock market in Nepal and the lessons learned from its three year experience.

While capital markets had its beginnings much earlier through the establishment of the Securities Exchange Center, a market based system of securities trading was adopted only in 1994. The amendment in the Securities Exchange Act which enabled this change allowed the entry of private intermediaries and set up an oversight agency - the Securities Exchange Board. Following this change, the capital market in Nepal has witnessed high growth. The primary market, in particular, grew almost five times and has sustained this growth over the past three years. The secondary market too, has grown, with market capitalization almost triple the levels three years ago and price index climbing to almost double the level when the Stock Exchange opened.

However, this period has been quite volatile, especially in the short term, as is common in most emerging markets. The market has gone through three types of periods, namely, a speculative period, a correction period and a stabilization period. The initial speculative period which lasted about six months was marked by a strong bullish market, where prices rose rapidly across the board without any regard to its fundamental financial value. During this period, there was very high liquidity in the market, with a heavy demand for the limited number of shares. This excessive demand was also caused by the limited investment alternatives, especially at a period of low interest rates. Subsequently, during the correction period, market prices crashed as people began to offload their overvalued shares. This bearish market persisted for almost a year resulting in a serious erosion of investor confidence. This slump continued until share prices came to levels which could be supported by their underlying values. The market has remained fairly stable since that time, entering into a more mature stabilization period. During this period, the market is much less volatile. But,

the market is also much less liquid with turnover levels substantially lower than previous year's levels.

This market trend can be attributed to factors which are quite common across nascent, emerging markets. There is a relative dearth of companies which can be listed and traded. One of the biggest reasons is the reluctance of profitable private companies to go public since their financial information which needs to be disclosed by public companies will no longer be hidden from tax authorities. In Nepal, the commercial banking sector is relatively well-developed and banking relationships with large, strong business houses are already established. Hence, the need to resort to capital markets for financing is less strong. Since the market is very limited, there are only a few number of market intermediaries, creating an oligopolistic market structure with functional overlaps which could have very conflicting interests. Regulatory enforcement to rectify such problems is weak owing to inadequacies in the legal code and fear of regulatory overkill in a limited market. In Nepal, this problem is heightened by the overlapping ownership structure of institutions. As a result of these factors, the market is prone to manipulation which is extremely difficult to track and even more, to take action upon. Hence, these economic and institutional factors make emerging markets very volatile and unpredictable, often inviting comparisons with gambling dens.

At the same time, a healthy capital market mirrors the state of economic development of the country, providing a catalytic role in increasing savings and investment in the country. Hence, it is the objective of all policymakers to try to ensure a healthy, sustainable and stable growth of capital markets. For this, they should try to increase the supply of tradable securities by way of allowing a variety of market instruments which can cater to the different needs of the investors and companies, providing fiscal incentives and placing legal requirements for companies to go public, and creating a favorable legal environment which minimizes the costs associated for companies to list on the stock market. To promote a healthy, competitive market, policymakers should seek to increase the number of market intermediaries and investors, both individuals as well as institutional. The latter is particularly important after the market has stabilized so that there is enough liquidity in the market. The regulatory environment also needs to be strengthened. A two tier regulatory system of self-regulation and oversight regulation has to be developed. It is only when there is a healthy, competitive institutional structure supported by liberal and stable economic policies facilitating increased savings and investments in the country that the capital markets can grow.